REPORT TO:	**FINANCE and MANAGEMENT COMMITTEE - SPECIAL**	**AGENDA ITEM:** 7
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REPORT FROM:	**CHIEF EXECUTIVE OFFICER**	
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SUBJECT:	**HOUSING REVENUE ACCOUNT SELF FINANCING: TREASURY MANAGEMENT and FINAL PROPOSALS FOR DEBT TAKE-ON**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the Council adopts a "two pool" approach to the management of its debt with effect from 1st April 2012.

1.2 That the Council finances the debt-take-on using a balanced portfolio structure as detailed in the report (**Option 3**).

1.3 That this strategy is kept under review in the light of any significant changes in interest rates prior to 26th March 2012.

1.4 That the final Treasury Management Strategy and Prudential Indicators are reported to Full Council on 28th February 2012.

2.0 Purpose of Report

2.1 To consider the most appropriate way to fund the Housing Revenue Account's (HRA) debt settlement under the self-financing framework. This follows previous reports to the Committee in the last year and in particular the report in October 2011.

2.2 Following analysis of various options, it was approved to finance the debt take-on through the Public Works Loans Board (PWLB) on a maturity type basis in order to satisfy the requirements of the HRA's 30-year Business Plan.

2.3 A firm of Treasury Advisors has since been appointed and they have worked with the Council to consider options and analyse the best portfolio structure including a full risk analysis.

- The funding solution should have no detriment to the General Fund (this is contained in accounting regulations).

- The HRA Business Plan cannot afford debt repayment during the first 5 years.

- Following this, it is assumed that surpluses generated via HRA self-financing will be used to finance gradual debt repayment.

- The Council has limited existing debt and no significant capacity through cash reserves to fund part of the settlement.

Current Economic Outlook

4.2 Stress in the financial markets continues to remain extremely high. Banks continue to fund most of their day to day operations internally (between each other) and this is a clear signal that there is risk within the markets.

4.3 Inflation has moderated slightly over the last couple of months. The Bank of England expects domestic inflation to reduce significantly in 2012 as the twin effects of the VAT and oil price increases fall out of the 12 month series.

4.4 Economic growth remains very low and uncertain. The UK position is being exacerbated by the situation in Europe and a prolonged period of subdued or even negative growth is expected. Recent data and surveys highlight low confidence and weakness and this is leading to tighter credit conditions.

4.5 Therefore, it is considered unlikely that interest rates will rise in the foreseeable future to force a rise in the price of money. The UK is still seen as a safe haven for investment and ensures that gilts (effectively the Government's cost of borrowing) remain low. This is the basis on which the PWLB fix their rates.

4.6 Some investors are questioning the UK's credit worthiness given the fragile state of the economy and the public finances. However, the current problems in Europe could take months and even years to fix.

4.7 Therefore, as long as the UK is able to hold onto its AAA rating status, UK bonds will continue to be regarded as the best option. Given the situation in Europe, this has left some commentators predicting interest rates may not rise until 2016.

Sources of Funding

4.8 Previous reports to the Committee have analysed options for funding the debt take-on. This included internal borrowing, issuing bonds, bank loans and the use of financial instruments such as LOBO's and derivatives.

4.9 Based on the analysis considered by the Committee in October 2011, the PWLB was approved as the funding source. In addition, to satisfy the requirements of the Business Plan, maturity loans were considered to be the most suitable option.

4.18 The risk with this strategy is that if rates fall, the Council will be fixed in at a higher rate and any debt restructuring would prove expensive. However, as highlighted previously, current rates are at historically low levels. At settlement date, there will be an attractive opportunity to secure a significant proportion of funding at long-term levels of around just 3%.

4.19 This would provide certainty of rate with limited downside risk. Should debt repayment become an option at a later date (i.e. the Council is in a position to repay early) when interest rates are higher, then premature redemption would be secured on preferential terms (assuming current PWLB policy).

4.20 The alternative to debt repayment would be to invest surplus resources. The decision would be dependent on projected cash flows and on-going capital funding required. However, if the Council built substantial cash resources it would need to justify why these were being held, rather than invested in the housing stock or used to repay debt.

4.21 In addition, investment returns are expected to remain subdued for a long period, potentially creating a "cost of carry" whereby investment returns are lower than the corresponding cost of holding debt. If investment returns remain subdued for longer than anticipated the cost of carry could be become expensive.

4.22 Credit risk regarding the on-going problems in the financial markets is expected to remain high. This supports a policy whereby large cash reserves are not accumulated at least in the short to medium term.

Borrowing Debt at Variable Rates

4.23 The PWLB offer both fixed rates (the rate applies for the duration of the loan at transaction date and does not change) and variable rates where the rate is changed on a six monthly basis in accordance with prevailing market conditions.

4.24 Initially, variable rate funding may appear counter-productive – why borrow on a variable basis if rates are expected to rise? Over the last 10 years, PWLB variable rates have averaged 3.7%. Back in 2001 and during 2007/08, they peaked at 6%, but have been less than 1% since 2009.

4.25 Effectively, the borrower is subject to the economic cycle, experiencing a higher cost in upswings in activity countered by low rates during the downturns.

4.26 As previously highlighted, rates are not expected to rise in the foreseeable future and then only gradually thereafter. There is an opportunity to take advantage of some very low rates of interest in the shorter term and consequently variable rate borrowing is a valid option for an element of the portfolio.

4.27 This is supported by the uncertain outlook for interest rates. It is considered that any recovery that may be on the horizon could easily slip back into reverse. An exposure to variable rates would allow the Council to participate in

LOANS

Interest Calculation	Repayment Method	Principal (£)	Period (Years)	Rate (%)
Fixed	Maturity	1,500,000	1	0.68%
Fixed	Maturity	1,500,000	2	0.82%
Fixed	Maturity	2,000,000	3	1.02%
Fixed	Maturity	1,500,000	4	1.27%
Fixed	Maturity	2,000,000	5	1.54%
Fixed	Maturity	2,500,000	6	1.81%
Fixed	Maturity	2,000,000	7	2.07%
Fixed	Maturity	2,500,000	8	2.30%
Fixed	Maturity	2,500,000	9	2.49%
Fixed	Maturity	2,000,000	10	2.65%
Fixed	Maturity	3,000,000	11	2.78%
Fixed	Maturity	3,500,000	12	2.88%
Fixed	Maturity	3,500,000	13	2.96%
Fixed	Maturity	4,500,000	14	3.03%
Fixed	Maturity	3,500,000	15	3.09%
Fixed	Maturity	4,500,000	16	3.14%
Fixed	Maturity	4,500,000	17	3.18%
Fixed	Maturity	5,000,000	18	3.22%
Fixed	Maturity	5,000,000	19	3.25%
Fixed	Maturity	733,000	20	3.29%
TOTAL / WEIGHTED AVERAGE		**57,733,000**	**10.5**	**2.63%**

- **Option 2** – take all new borrowing on a fixed rate, long-term basis to mature in 30 years time. This option assumes no interim debt repayment and surplus balances are invested, i.e. a Long Dated Option.

LOANS

Interest Calculation	Repayment Method	Principal (£)	Period (Years)	Rate (%)
Fixed	**Maturity**	**57,733,000**	**30**	**3.45%**

- **Option 3** – a balanced portfolio incorporating elements of Options 1 and 2 which allows some variable rate funding. This is designed to balance out the risks, maintain flexibility and achieve a low rate portfolio.

LOANS

Interest Calculation	Repayment Method	Principal (£)	Period (Years)	Rate (%)
Variable	Maturity	10,000,000	10	0.70%
Fixed	Maturity	10,000,000	12	2.88%
Fixed	Maturity	10,000,000	15	3.09%
Fixed	Maturity	10,000,000	20	3.29%
Fixed	Maturity	10,000,000	25	3.40%
Fixed	Maturity	7,733,000	30	3.45%
	TOTAL	**57,733,000**	**18.7**	**2.78%**

Interest Rates – on-going Borrowing	Exposure to an adverse movement in rates (upwards)	Medium	Low	Medium
Interest Rates – Investments	Exposure to an adverse movement in rates (downwards)	Low	High	Medium
Political / Policy	Adverse change in PWLB lending / repayment / interest rate policy	High	Medium	Medium
Inflation	Rental income linked to inflation and rent convergence. Risk that lower inflation reduces income when debt costs are fixed, especially over a longer-term	Medium	High	Medium
Market	Affects premium levels for premature repayment	Low	High	Medium
Legal and Regulatory	Compliance with statutes and codes of practice	Low	Low	Low
Operational, Fraud and Error	Size of the settlement and transacting on one day increase the risk	Low	Low	Low

Conclusion – Debt Structure

4.43 A balanced approach (Option 3) is recommended. £10m of the settlement can be funded using 10 year PWLB variable rate debt. This provides a low rate of interest, flexibility on premature repayment and can be used to offset any "cost of carry" relating to corresponding investments.

4.44 The remaining settlement is funded utilising a mixture of fixed rate maturity PWLB loans as identified in Option 3. It is considered that this will provide a balanced approach to maturity structure regarding interest costs, fixed and floating interest rates, together with average life. All debt would be paid within 30-years.

4.45 This is based on projected interest rates on 26th March; these could vary. Therefore, the structure should be reviewed prior to agreeing terms.

4.46 For example, a significant reduction in long term rates may result in a bias towards longer-dated debt (Option 1) and/or less variable rate debt. An increase in rates may prompt an increase in variable rate proportions or a shortening of the overall debt portfolio.

Comparison / Effect on the HRA Business Plan

4.47 The approved Business Plan is based on a straight cost of debt at 5.75% over the entire 30-years. The Plan also starts to physically repay debt from Year 5. The Plan demonstrates that repayment is achievable in 30-years – a benchmark / test of the affordability of the longer term business.

4.56 With the introduction of self-financing, the Council will need to allocate these loans between the General Fund and the HRA. The Chartered Institute of Finance and Accountancy (CIPFA) have developed the accounting practice which will be used to determine the allocation.

4.57 Firstly, the debt relating to transferred assets can be directly allocated to the HRA as it relates to council houses. Splitting the £1m is more technical and relies on an analysis of the Council's Balance Sheet, split between the General Fund and HRA. This is shown as follows:

Measure of Net Indebtedness	General Fund (£)	HRA (£)
Capital Financing Requirement (CFR)	8,464	5,459
Usable Reserves	-8,750	-2,637
Net Indebtedness	-286	2,822

4.58 The CFR is effectively a measure of the underlying borrowing requirement. In respect of the General Fund, this is totally being financed by reserves and balances.

4.59 Due to the HRA having a net indebtedness which is greater than total debt outstanding, by default, the net debt (£2.8m) is being met in part by the external borrowing (£1.2m). Therefore, under the accounting principles, all the debt will be allocated to the HRA.

(The remaining balance on the HRA is effectively being funded by cash deposits held in the General Fund).

4.60 The total cost of the existing debt is £82,720. Under the prescribed formula, £76,240 is currently charged into the HRA. Therefore, an increase of around £6,500 will be charged into the HRA under self-financing.

4.61 Provision will also need to be made in the HRA Business Plan for the market loan to mature in 2032.

Pooling of Debt

4.62 Given the split of debt as detailed above, it would appear that operating a "two pool" system with separate debt pools allocated to the General Fund and the HRA is the optimum solution for the Council.

4.63 The General Fund Pool will effectively be zero at the transition date. This approach allows a clear distinction to be achieved between the HRA (including the debt take-on) and other Council debt. This also allows different strategies to be applied and is administratively easier to achieve and maintain.

4.64 Importantly, this also demonstrates that there has been no detriment to the General Fund on transition – a key aim of the self-financing proposals.